

Internal Revenue Service
memorandum

CC:TL:Br2
JKHarris

date: JUN 16 1986

to: District Counsel, Newark CC:NEW

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your memorandum of April 2, 1986, in which you request technical advice regarding the above-captioned case. You request advice concerning whether a National Office Technical Advice Memorandum that is substantially similar to this petitioner's situation remains viable in view of a later decision in Xerox Corporation v. United States, 656 F.2d 659 (Ct. Cl. 1981).

ISSUE

Whether school buses, vans and station wagons purchased by the taxpayer and used to transport pupils of local school districts, pursuant to contracts with the school district, are eligible for the investment tax credit pursuant to Internal Revenue Code § 38. 0048.03-00.

CONCLUSION

School buses, vans and station wagons used by the taxpayer to furnish transportation services to local school districts pursuant to written contracts are eligible for the investment tax credit.

FACTS

During the taxable year, taxpayer purchased school buses, vans and station wagons (hereinafter vehicles) to be used to transport pupils to and from school or school related activities. The taxpayer is generally in the business of furnishing bus transportation services. State law requires all public school districts to provide transportation for pupils in its district, either by purchasing buses, contracting for services or using public transportation.

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In the instant case, the school district contracts for the services and requests bids using a form which specifies the requirements of the school district. This form requires that:

- 1) The contract must be approved by the State Education Department.
- 2) The school district controls the times and routes of bus operation.
- 3) The contractor must carry personal liability insurance for a specified amount, with the school district named as an insured party.
- 4) The school buses must comply with State and local specifications for such vehicles.
- 5) The drivers of the vehicles must have licenses and qualifications required for school bus drivers under State and local regulations.
- 6) Payment is based on a flat amount per year per pupil transported.

After bids are reviewed and accepted, a contract is entered into; the contract may be renewed without repetition of the bidding process.

Local school districts are the source of [REDACTED] of the taxpayer's business. The drivers of the vehicles are employees of the taxpayer. The taxpayer is responsible for maintaining the vehicles. The taxpayer decides which vehicle and which driver to use on a specific route on any given day. The insurance policy purchased by the taxpayer covers the use of the vehicles for carrying any children, not just school children.

DISCUSSION

Code § 38 provides a credit against income tax liability for a taxpayer's investment in certain depreciable property used in its trade or business.

In general, Code § 48(a)(1) defines "Section 38 property" as tangible personal property used by a taxpayer in its trade or business with respect to which depreciation (or amortization in lieu of depreciation) was allowable and having a useful life (determined as of the time the property was placed in service) of 3 years or more.

Code Section 48(a)(5), as amended by Section 31(b) of the Deficit Reduction Act of 1984, provides as follows in pertinent part:

(5) Property used by governmental units or foreign persons or entities.--

(A) In General.--Property used--

(i) by the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing, or

* * * *

shall not be treated as section 38 property.

(B) Exception for short-term leases.--

(i) In general.--This paragraph and paragraph (4) shall not apply to any property by reason of use under a lease with a term of less than 6 months (determined under section 168(j)(6)).

Section 7701(e) of the Code, as added by Section 31(b) of the Deficit Reduction Act of 1984, provides as follows:

(e) Treatment of Certain Contracts for Providing Services, Etc.--For purposes of chapter 1--

(1) In general.--A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not--

(A) the service recipient is in physical possession of the property,

(B) the service recipient controls the property,

(C) the service recipient has a significant economic or possessory interest in the property,

(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and

(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Section 31(g)(1) of the Deficit Reduction Act of 1984 provides that the above code sections apply to property placed in service by the taxpayer after May 23, 1983, or to property placed in service by the taxpayer on or before May 23, 1983, if the lease to the tax-exempt entity was entered into after May 23, 1983.

As you are aware, in Xerox the Court of Claims held that the taxpayer was entitled to the investment tax credit on the grounds that copying machines placed on the premises of governmental units and tax exempt organizations under rental agreements were not leased to them, but were supplied as an integral part of a service contract. In Xerox, the court examined all the facts and circumstances and enumerated nine factors it found determinative of a service contract and not a lease. 656 F.2d 675-7.

However, the addition of Code § 7701(e) by the Deficit Reduction Act of 1984 represents a modification of Xerox and a prospective change in controlling legal principles. Code § 7701(e) essentially codifies the legal standard enunciated by the Court of Claims (now the United States Court of Appeals for the Federal Circuit) in Xerox. As set forth above, this Code section enumerates six factors to be evaluated in determining whether a transaction is to be treated as a service arrangement or a lease of property. The legislative history of Code § 7701(e) emphasizes that the determination of lease versus service arrangement is to be made on the basis of all relevant factors, including, but not limited to, the six statutory factors. See Rep. No. 169, Vol. II, 98th Cong., 2d Sess., 139 (1984); General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation 98th Cong., 2d Sess., 59 (Comm. Print 1984).


Based on the information submitted to this office, it appears that the contracts at issue are service contracts after an application of the criteria set forth in Code § 7701(e). That is, the taxpayer is in physical possession of the property and controls its use (see § 7701(e)(A) & (B)); further, the taxpayer has a significant economic interest in the property -- i.e., the taxpayer has title to the property (see § 7701(e)(C)); and the taxpayer stands to lose substantially all his income if there is nonperformance under the contract since [REDACTED] of his business is generated by his school district contracts. (see § 7701(e)(D)).

CONCLUSION

Accordingly, the contracts at issue in the instant case do not appear to be leases within the meaning of Code § 7701(e), although, as noted above, such a determination must be made on the basis of all relevant factors, not just the six statutory criteria. Assuming the balance of the information available in your office supports a conclusion that the contracts are not leases, the vehicles would be eligible for the investment tax credit pursuant to Code §§ 38 and 48.

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Director

By:


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